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SUBJECT: RUSSIA'S ECONOMY: OIL STILL RULES, BUT CONSUMER BOOM SPURS DIVERSIFICATION

Sensitive But Unclassified -- Not for Internet Distribution.

Summary

¶1. (SBU) Oil has dominated the Russian economic landscape since before the 1998 crisis. Its revenues have put the government's budget in positive territory since 2002; it has strengthened the ruble, and kick-started a wage increase that is sustaining a spending boom. Yet, oil's prominence in Russian growth patterns is slipping while consumer trends remain strong, as shown by employment, investment and revenue trends. Russia will unlikely ever escape its oil dependency, but there are signs of growing diversification as well as a nascent independence from oil industry performance, which suggests the economy is increasingly protected from even a major oil price downswing. End Summary.

The Russian Economy: One-Trick Pony?

¶2. (SBU) It would be difficult to overstate the importance of oil's contribution to the Russian economy since 2000. Non-oil fiscal balances have been negative since 2002. Oil extraction and export taxes, at almost USD 40 billion in 2005, accounted for 32 percent of government revenues, producing budget surpluses in the 6 to 7 percent of GDP range in recent years. And this is not due to just higher prices -- production has risen sharply, with Urals crude oil output up 50 percent since 1999. Crude and refined oil products constituted 54 percent of total exports in 2000 and 65 percent in 2005.

¶3. (SBU) Oil was the rising tide that lifted all boats from 1999 to 2001. Large-scale capital investments in the petroleum industry during the period (USD 997 million in 1999; USD 6.3 billion in 2000; and USD 4.5 billion in 2001 according to official statistics) primarily aimed at enhancing efficiency, spurred corresponding increases among sectors involved in bringing the product to market. The main beneficiaries pulled along by these gains were transportation, engineering services, machine building and construction. In that period, a strong correlation emerged between the price of oil and wages throughout the economy.

Other Sectors Breaking Out

¶4. (SBU) But the story does not end there. Ever higher

crude oil exports have driven current account surpluses for 7 straight years (12.6 percent of GDP in 1999; 10.9 percent in 2005). These, in turn, have boosted real ruble appreciation. Historically, oil profits were invested abroad, but Andrey Klepach, Director of Macroeconomic Forecasting at the Ministry of Economic Development and Trade (MEDT) notes that the combination of a strengthening ruble and rising consumer demand has led to a reversal in the investment destination of petrodollars. United Financial Group Chief Economist Yaroslav Lissovolik adds that the beneficiaries of foreign direct investment (FDI) are also shifting: the energy sector claimed 46 percent of FDI in 2004 but only 33 percent in
¶2005. Official statistics also show that nominal FDI into non-energy sectors increased 70 percent between 2004 and
¶2005. Lissovolik sees "behind-the-scenes diversification" in booming service sector growth.

¶5. (SBU) Investment, in turn, is spurring higher rates of return outside the energy sector. Consumer goods, both wholesale and retail, have outperformed the oil sector since 2003, with real growth rates of 13.2 percent in 2003, 11.2 percent in 2004, and 12.3 percent in 2005. The annual flow of foreign investment into the retail sector has tripled in the last three years, rising from USD 109 million in 2003 to USD 319 million through August 2006, according to official statistics. Retail employment is also trending up: growing 5.7 percent in 2004 and 7.4 percent in 2005 (despite an overall contraction in the labor force of more than one percent in both years). Employment in the hotel and catering business is picking up steam, growing 15.6 percent in 2005, with similar rates expected for 2006; and the same trend is evident in retail sector employment. Foreign investment flows into the hotel industry have grown from USD 8 million in 2003 to USD 20 million in 2005, and will be significantly higher in 2006, if the construction we have witnessed around

the country is any proof. The financial services sector has also been steadily advancing, growing by 9.6 percent in 2003, 4.5 percent in 2004, and 6.4 percent in 2005, with foreign investment flows into the sector jumping from USD 112 million in 2003 to USD 526 million in 2005. This is also one of the sectors which would experience a significant boom under a WTO accession scenario.

Oil is Key to Growth
. . . But Just For Now

¶6. (SBU) Finance Minister Aleksey Kudrin believes Russia is less and less vulnerable to swings in the world price for oil. He says that in 2000, a one-dollar change in the per-barrel price of oil caused a 0.2 percent change in GDP growth; by 2005, the coefficient fell to 0.06 percent, and by 2006, to 0.04 percent. Using the latter coefficient, a USD 40 drop in the per-barrel price of oil this coming year would knock Russia down to 5.5 percent growth rates -- hardly a catastrophe. MEDT's Klepach estimates that energy is responsible for only one-third of today's GDP growth, and he claims his calculations account for the impact of energy-sourced liquidity that has financed other sectors. He anticipates energy will soon fuel only one-quarter of total GDP growth, giving way to advances in the high-tech, automotive, and retail sectors. A non-energy GDP, by that measure, could still reach 4-4.5 percent in 2007.

¶7. (SBU) MEDT's Andrey Klepach also believes that wage growth (a key component in the current consumer drive) has been independent of the oil extraction industry's performance since 2002. He notes that while oil industry growth rates have declined (10.3 percent in 2003; 7.2 percent in 2004; 1.7 percent in 2005, and an estimated 2 percent in 2006), wages have experienced double-digit growth over the same period. Wage levels, he notes, are now closely tied to productivity in a growing number of consumer sectors, from retail and telecommunications to tourism and automotive.

Comment

¶8. (SBU) Oil remains the prime driver of the Russian economy and Russia a key contributor to world oil output: the country's annual increases have accounted for 47 percent of the worldwide increase in annual oil production since 1999. More than one-third of the Russian stock market's total capitalization is currently concentrated in 4 oil companies, LUKOil, Rosneft, Tatneft and GazpromNeft, and oil exports have helped keep current account balances positive. All this is abundantly true. But, absent a new infusion of capital, hydrocarbons look likely to decline as a source of new growth and vitality for the country. And there is also mounting evidence that the non-oil, and non-gas, sectors are emerging as engines of growth, with the consumer and financial sectors poised to push forward, especially as the spending and investment boom continues its spread across the regions.
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